### VAT focus

**C&D Foods: the Good, the Bad and the Ugly**

#### Speed read

In the recent case of C&D Foods Acquisition ApS (Case C-502/17), the CJEU has ruled that there should be no deduction of input tax following an aborted sale of shares in a group subsidiary given the intention to use the proceeds to pay down debt. The CJEU found the aborted sale was outside the scope of VAT, as the purpose meant there was an insufficient link to the overall economic activity of the taxpayer. As paying down debt is a common business activity, the decision has raised concerns that VAT recovery could now be blocked in more instances than seems appropriate. To improve one’s chances of recovery, any VAT incurred should be correctly charged to the right entity; appropriate documentation should be kept to evidence the intended links to economic activity and taxable supplies. Consideration should be given to the stated intentions of the parties and also to the links between costs and planned onward supplies.

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**Peter Dylewski**

KPMG

Peter Dylewski leads KPMG's EMA region financial services indirect tax practice.

He has more than 17 years' experience in FS VAT, with a particular focus on technology, asset management and international VAT issues. Email: peter.dylewski@kpmg.co.uk; tel: 020 7311 8497.

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**Sarah Daley**

KPMG

Sarah Daley works in KPMG’s financial services VAT team in London having previously spent seven years at the Bar. She has a particular focus on the banking and asset management sectors with recent work including questions of establishment, VAT grouping and the liability of platform services. Email: sarah.daley@kpmg.co.uk; tel: 020 7694 3487.

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**A fistful of VAT**

With the distinguished Italian film composer Ennio Morricone having recently celebrated his 90th year with a farewell concert in London, it seems appropriate to revisit one of his greatest triumphs. Sergio Leone’s classic 1960s spaghetti western *The Good, the Bad and the Ugly*, punctuated by Morricone’s legendary score, depicts the titular trio in a desperate treasure hunt. In the course of the movie, the Good has to sever a hangman’s noose around the Ugly’s neck on several occasions to save him from death. The film culminates in a fatal three-way duel with (spoiler alert) no gold for the Bad, the Good riding off into the sunset with part of the loot, and a question mark over whether the Ugly will ever get to enjoy his share.

What immediately comes to mind for a VAT practitioner, of course, is that all this is an elaborate and prescient metaphor for the challenge of VAT deduction which was to come in subsequent years. Once one realises that the Good represents taxable supplies, the Bad stands for exempt supplies and the Ugly encompasses non-economic activity, a deeper potential significance of the movie becomes apparent.

Where there is a direct and immediate link to Good (taxable) supplies, you can ride off with the input VAT. Where there is a clear nexus to Bad (VAT exempt) supplies, you will be left lying in the dust with no money. Where, however, outside the scope activity is involved, the situation can turn Ugly. If Good supplies are close enough to sever the noose linking the costs to non-economic activity, some recovery may be possible. Otherwise a grizzly end awaits – with no VAT deduction at all.

#### For a few euros more

The issue of VAT deduction has been a frequent topic for the courts, given the amounts at stake for both sides. As VAT is a teleological tax, purpose is key to determining its application in many instances. However, as this purpose has in many instances never been exhaustively documented in the legislation or associated working papers, this leaves it up to the Court of Justice of the European Union (CJEU) to act as marshal and clean up town when there is a dispute. The CJEU, of course, does not invent new law. It declares (some may say even discovers) what the law has always been, even when this has not been clear to member states, taxpayers and practitioners alike for the better part of the last nearly 50 years. This inevitably leads to challenges in matching the court’s judgments to historic practice.

As the court’s pronouncements are also triggered by specific cases, they do not naturally lend themselves to comprehensive statements which can easily be applied more broadly. This leads to a pattern of frequent disputes between taxpayers and tax authorities, and return trips to the CJEU to try and break the deadlock. A particularly difficult area is the question of expenses incurred by holding companies.

Before looking at the latest case in the line, it is helpful to survey the key principles arising from the authorities to date, which should help to explain the interplay of the Good, the Bad and the Ugly for VAT purposes.

#### Once upon a time in Luxembourg

For VAT to be reclaimed as input tax, certain principles have emerged from the case law of the CJEU:

- the taxpayer making the claim must have received the supply for the purposes of its business; and
- the supply must have a sufficient link with its onward taxable supplies, either directly or through a nexus with its overall economic activity.

VAT cannot be claimed on a non-business or private expense, nor on an expense that is attributable to exempt activities.

There is, however, no prescriptive legislative test as to whether goods or services have been received for the purposes of the ‘business’. Where the connection is not clear, two tests can in turn be applied to determine if the input tax is recoverable:

- The first test, which might be termed subjective, seeks to determine the intention of the person at the time they incur the expenditure. Where there is no obvious connection between the expenditure and the business, the court would treat any assertion that it is with circumspection and care.
- The second test considers objectively whether the
expenditure relates directly to the functioning of the business by looking at the intrinsic nature of the expense and the use to which the goods or services are put.

Expenditure which benefits the business is not always seen as being incurred for the purpose of the business – which then prevents a link with the taxpayer’s economic activity and blocks recovery.

‘I’ll keep the money and you can have the rope’
The case law talks about the need for a ‘direct and immediate link’ between a supply received and a supply made in order to evidence the potential right to VAT deduction. One way in which this can be proven is by showing that the supplies received are ‘cost components’ of transactions which carry the right to deduct associated input tax.

If relevant costs incurred are included in the price set for the onward supplies, this might seem a fairly straightforward test. If the costs borne are not reflected directly in prices but form part of the business’s general costs set against its income in determining overall profit, then they are arguably general overheads. Such expenses are cost components of some or all of the business’s supplies and can achieve at least partial VAT deduction depending on the business’s partial exemption position.

The recent case of Volkswagen Financial Services (Case C-153/17) has confirmed, however, that the direct and immediate link test requires objective consideration of the connection to the business’s supplies and that a crude mapping through of costs to final prices is not necessarily determinative.

The supply with no name
One of the biggest open questions centres around whether expenditure linked with activity or income which does not constitute taxable or exempt supplies can still have a sufficient nexus with taxable supplies in order to allow recovery.

In C&D Foods Acquisition ApS (Case C-502/17), the eponymous taxpayer was the parent holding company of Arovit Holding, which in turn owned Arovit Petfood. C&D Foods was engaged in providing management and IT services to the latter. Kaupthing Bank, an unconnected third party, assumed ownership of the Arovit group when the latter failed to repay a loan. The bank intended to sell all of the shares in Arovit Petfood and use the proceeds to settle the debt. Consultants were therefore engaged to advise on the sale process, which ultimately ended with no buyer being found.

The question was whether C&D Foods had the right to deduct the input VAT on the due diligence advisory fees, given that the proceeds of that sale were to be allocated to the repayment of a debt due. The advocate general had opined that there should be no recovery on the basis that this was a Bad situation. The aborted transaction would have been exempt, given it was a sale of a subsidiary to which management services for consideration had previously been provided. The associated costs were thus blocked, even though the sale had never been completed (in line with the decision in another recent case, Ryanair (Case C-249/17)). This was an ending which most (VAT) viewers were expecting.

It would have been a ‘remake’ of BLP Group Plc v C & E Chambers (Case C-4/94) where a group needing to pay off debts had also sold shares in a subsidiary. That case provides authority for the proposition that you cannot look beyond the exempt supply to which the cost is directly and immediately linked to the ultimate purpose of the expenditure. Where there is a clear link to taxable supplies, this is a Good situation and VAT deduction is secured. Where costs directly relate to VAT exempt supplies, this is Bad and no VAT may be deducted, regardless of the use you planned to make of the money. The CJEU denied recovery and prevented looking through the VAT exempt share sale to what was done with the money, as ‘the ultimate aim pursued by the taxable person is irrelevant’. However, the referral in that case had stated that the sale was an exempt supply, so strictly the CJEU never questioned that key conclusion and assumed the reference concerned a Bad situation.

In C&D Foods, by contrast, the CJEU did consider the nature of the share sale more closely but decided it was dealing with an Ugly situation. It markedly questioned which entity had in fact received the supplies in question, a matter for the referring court. It then reiterated the need to consider the objective content of the transactions in determining whether there is a direct and immediate link with a taxable output. It also referenced the need to take into account the ‘exclusive reason’ underpinning the intended sale as important evidence for determining that objective content. For the share transaction to come within the scope of VAT, it held that the direct and exclusive reason behind it must in principle be the ‘taxable economic activity’ of the parent company in question.

The court found that since the core objective of the disposal of the shares was to settle the debts owed to Kaupthing Bank, this could not be deemed to be a transaction for which the direct and exclusive reason was the taxable economic activity of C&D Foods. The intended share sale did not therefore come within the scope of VAT.

The court considered that there was an insufficient link to the cessation of the taxable supply of management services. VAT on the due diligence fees would have been deducted, but no management services had been provided to Arovit Petfood. Kaupthing Bank intended to sell its shares in any event.

Bad dubbing?
The precedent for seeing the use of sales proceeds to pay down debt as something not for the purposes of the business is surprising at first sight and unwelcome. The case has raised concerns in some quarters that some new purposive look-through test has been discovered, which now needs to be taken into account whenever determining VAT deduction. This could undermine otherwise Good claims to deduction, but also allow arguments for a link to taxable supplies in scenarios previously considered Bad per the BLP principle, if the Ugly activity does not consume all the VAT (a big if, given the CJEU’s conclusions). The reference to the purpose of the costs needing to be ‘exclusively’ tied to the ‘taxable economic activity’ also appears to break new ground.

Looking at the particular fact pattern of this case holistically, however, the basis of the refusal to allow the input tax deduction is, in the authors’ view, understandable and reconcilable with the approach to date. The fact pattern set out in the case shows the third party creditor, Kaupthing Bank, as the main actor, apparently driving the decisions for the sale and the
use of the due diligence consultants all in pursuit of repayment of the debt to it. The CJEU was not asked to address the issue of to whom the due diligence supplies were made, but nevertheless questioned this point at length as a preliminary matter. The court was clearly concerned that, regardless of which entity paid for them, the due diligence supplies were made to Kaupthing Bank, breaking one of the fundamental principles of VAT deduction which we set out earlier.

This concern over a lack of a sufficient link to C&D’s own business activities then carries over into the court’s analysis of the nature of the intended share sale. This is not seen, per other case law principles, as the ‘direct, permanent and necessary extension’ of the holding company’s taxable activity; and the court clearly sees a strong direct link to Kaupthing’s business which prevents other arguments linked to the holding company’s management services to the subsidiary.

In BLP, the CJEU explicitly agreed with the taxpayer’s proposition that, had it taken out a bank loan to pay the debts, the associated VAT on advisory costs would have been legitimately claimable as overheads. This makes it clear that the characterisation of the share sale purpose in C&D Foods is specific to the case and not a general proposition to be followed wherever a company uses sales proceeds to pay down debt.

The reference to the taxpayer’s ‘taxable economic activity’ is at first sight more challenging. Does this mean that the use of share sales proceeds need to be traced through to planned taxable supplies? We would argue that is not the case. In terms of language differences, in a European context the term ‘exempt’ is used to cover both VAT exempt supplies and what we in the UK see as outside the scope activity. In the same way, ‘taxable’ can be used to mean ‘within the scope of VAT’ – a less familiar usage to UK ears. The authors would argue that this is the way ‘taxable’ is being used here – and that the principle being stated is therefore no more than saying that the purpose of the expenditure must be linked to economic activity within the scope of VAT, in order for the share sale itself to be within the scope of VAT.

As the CJEU made clear in the earlier case of Becker (Case C-104/12) (cited approvingly in C&D Foods), the exclusive purpose for a transaction is a legitimate matter to be taken into account. However, there is still a need to consider all the circumstances in which the transactions took place.

‘I always see the job through’
Whilst the authors believe that C&D Foods is distinguishable on its facts, there are certainly grounds in the decision for potential confusion and misinterpretation by tax authorities and taxpayers alike.

As was made clear in Becker, there is such a diversity of commercial and professional transactions that comprehensive all-encompassing guidance could not be given on the direct and immediate link test. The court emphasised that there was a need to take account of the objective content of the transaction because this was compatible with the aim pursued by a common system of VAT which seeks to ensure legal certainty and to facilitate the application of VAT. This point has been echoed by the advocate general in the more recent Sveda case (Case C-126/14). In situations where significant VAT reclaims are envisaged, it therefore remains important to ensure that:

- any VAT incurred is correctly charged and to the right entity;
- there is appropriate contemporaneous documentation in place to evidence the intended links to economic activity and taxable supplies; and
- consideration is given not just to the subjectively stated intentions of the parties but also to the objective links between costs and planned onward supplies.

Taxpayers in an Ugly situation should thus be prepared and able to distinguish their own facts in the event of a showdown to avoid finding themselves lying on a pile of gold with their hands tied.

For related reading visit www.taxjournal.com

Cases:
- C&D Foods Acquisition ApS v Skatteministeriet (13.11.18)
- M&A input tax recovery by holding companies: an elementary issue? (Peter Dylewski & Philippe Gamito, 17.02.17)